The Policy Pitch - Stagnation Nation? Australian investment in a low-growth world

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Australia risks descent into economic stagnation as the mining investment boom fades. Policymakers need to do more to ensure we remain a dynamic, growing economy. Australia is experiencing its biggest ever five-year fall in mining investment, as a proportion of GDP. And non-mining business investment has fallen from 12 percent to 9 percent of GDP, lower than at any point in the past 50 years, as discussed in Grattan's recent report, Stagnation Nation.

In this *Policy Pitch* event, three experienced policy analysts discussed the state of the economy and how policy can reignite investment:

- What explains the low level of investment in Australia?
- Why is company tax so controversial and how strong is the case for a cut?
- How does the broader policy agenda affect investment and growth?

Speakers: Dr Jim Minifie, Director of the Productivity Growth Program at Grattan Institute
Professor Rodney Maddock, Vice-Chancellor's Fellow at Victoria University and Adjunct Professor of Economics at Monash University
Professor Miranda Stewart, Director of the Tax and Transfer Policy Institute at ANU

ANDREW HISKENS: Good evening everyone. In the interests of ensuring that there's plenty of time for conversation, I'll start with the introduction while people are still coming in. My name is Andrew Hiskens, I'm the Manager of Learning Services here at the State Library, and it's a great pleasure to welcome you here for this evening's *Policy Pitch*. This seminar is held on the traditional lands of the Kulin nation and I would like to pay my respects to their elders and to any other elders who may be present with us this evening. I'd also like to give a warm welcome to tonight's speakers, Professor Miranda Stewart, Professor Rodney Maddock and Dr Jim Minifie, Grattan Institute members and staff, and Friends of the Library, and I'd like to thank you all for coming along this evening.

The Library is currently undergoing a very special time in our history because we recently publically revealed the new designs for the Library's Vision 2020 building redevelopment. It's an $88.1 million building redevelopment and over the next three years the library will be transformed, with 40% more space for public use - which, if you walk out into the public spaces around this time of year when it's very busy from university students, we really do definitely need that extra space - a new centre for entrepreneurship, exciting areas for families and children, and the re-opening of the Russell Street entrance and the historic Ian Potter Queen's Hall across the front of the building, which has been closed for more than a decade. Vision 2020 is being funded by the State Government, philanthropic donations and a public appeal, which is aiming to raise $27.1 million. So you, indeed, can be part of this moment in history by donating - this is my pitch to you tonight - to the Vision 2020 capital campaign and if you want to find out more about that you can go to the Library's website or pick up a brochure outside this evening.

You may also want to consider becoming a Friend of the Library, because through the Library's Foundation the Friends help the Library to buy and conserve a range of important collection items, as well as mount major exhibitions, events and programs, and that's only $85 a year, so it's a bargain really, all things considered. I have one other last word from our sponsor piece which is to say a number of Grattan events have focused on education with Pete Goss leading the team there. We're actually hosting an event called the Australian Learning Lecture down at the Melbourne Convention & Exhibition Centre on the 11th of May with Charles Fadel. Charles runs the Centre for Curriculum Redesign in Boston, he is on the visiting faculty at Harvard, and he also chairs a committee and consults to OECD, so he's reasonably interestingly well-connected in that space, and he's speaking on the topic of the new success, so in a changing world what does success look like for our young people and, indeed, for even older people, how are we framing that and how are we going to make those differences. So, those are the ads over.

Tonight we will hear about Australian investment in a low-growth world. We have three experienced policy analysts, Rod Maddock, Miranda Stewart and Jim Minifie, who'll discuss the state of the economy and how policy can re-ignite investment. I'm now very pleased to welcome Dr Jim Minified, Director of Productivity Growth at Grattan Institute, to lead the conversation. Jim directs the Productivity Growth Program at Grattan. His research focuses on developing policy to raise Australia's living standards by improving productivity and accelerating the speed of innovations. Prior to joining Grattan in 2012, Jim spent 12 years with Boston Consulting Group working with corporate and public sector leaders, including seven years as BCG's Chief Economics for Australia and New Zealand. He has a PhD in applied economics from Stanford University. Please join me in welcoming Jim.

JIM MINIFIE: Andrew, thank you very much. It's great to be part of this partnership with the wonderful institution that is the State Library. Welcome everybody. Before I introduce our other panellists let me say it's great to see such a big crowd. We're planning to record this event and put it on the web and have questions, so just bear in mind that this is a public event. It's really a great pleasure to introduce Miranda and Rod. The reason why I think the two of you are so interesting is that you've both had private sector experience, government experience and very, very significant research experience, so you've seen how the other half live in different capacities.

Let me start with you Miranda. You direct the Tax & Transfer Policy Institute at the ANU, but you're also on the faculty here at Melbourne University. In your academic career you've written pieces of work not just on tax and transfer narrowly, but as they pertain to the world of non-profits, the world of development, and also to this very complex world of corporate entities and cross-national transactions, and all of those things become increasingly important as technology makes it much easier for firms to operate across boundaries. The other component of what the Tax & Transfer Institute does is to look at the household sector as well where taxes and transfers are critical for managing life courses and so forth. It's a real pleasure to have you join us, Miranda. Rodney, you've got an equally peripatetic and wide-ranging set of interests. In your different incarnations you were the Chief Economic Advisor for the Victorian Cabinet Office, you were the Chief Economist at the Business Council of Australia. Some economists know you primarily as a historian, others primarily as a macroeconomist, and still others as a regulatory specialist, but the other hat that you wear and that you've probably been wearing more over the last 10 or 15 years is in the world of financial services where you were a senior executive including Head of Strategy for the Commonwealth Bank and currently the Head of the Australian Centre for Financial Studies. There's a lot of depth represented here with the panel and it's a real pleasure to introduce the set of topics, thank you very much for joining us.

So let me start with why we wrote the report called *Stagnation Nation* which we put out six or so weeks ago. With my co-authors, Lucy Percival and Cameron Chisholm, who are here tonight as well, we shared a concern that others have at Grattan: as the mining boom comes off, would Australia face some of the challenges to economic growth that the rest of the rich world saw? In some sense we had a six year holiday from some of those challenges but now, as the mining boom fades - mining output is growing, yes, but investment is dropping back to Earth and prices have come down substantially - maybe we're going to look a little bit more like your average developed economy. That hasn't been a happy sort of economy to be in in recent years, you've had either a combination of rising inequality in many of those economies, but not all of them, slow growth in many of them continuing to this day, and a general sense that things aren't working for everybody in the community. So we took the opportunity to ask some of those big questions, I don't think we answered all of them, and we ended up zooming in on business investment, which is the most variable part of GDP. It was really the collapse in business and also a significant collapse in housing investment in much of the rich world that led to the huge fall in GDP after the financial crisis in 2009 and 2010 and investment has been very slow to pick back up in much of the rich world. As a result, there's a big hole in the capital stock because if you don't invest things keep depreciating and wearing out and the quality of both the tangible capital stock, things like buildings and equipment, but also the less tangible, investment in R&D and, really importantly, investment in human capital, because people are out of the labour force, slows down and doesn't keep up

So let me just give an example. The US now has got an unemployment rate which is well below Australia's rate, but output per person has grown nothing like as fast in the US over the last eight or so years as it has in Australia, so they really haven't come out in certain respects from the hole. They're busy again, but they're not as rich as they would have been if they had continued to invest. So we tried to dig into some of those trends in Australia and the real striking finding is that non-mining investment has not picked up. As mining investment has dropped off in aggregate you see that it's remaining at a level which is significantly below as a share of GDP where it's ever been before, so that caused us to prick up our ears and try to understand what's driving that. I won't tell the whole story but, in short, what we found is that things aren't quite as bad as they look on the surface because the economy has changed in the meantime. If you go back 25 years to when manufacturing was well over 10% of the workforce and about 10% of GDP, you had a big agriculture sector that was also quite capital-intense, services were a smaller share of the economy, and indeed the whole business part of what people do for a living was bigger then than it is now. What's happened since then is health and community services have grown, so the business part of the economy in some sense has shrunk a little bit. The most capital-intense parts of the economy have shrunk as well and the average non-mining sector has become more capital-light, so they've found ways to generate output that just doesn't require as much investment to support it.

All of those things made us relax a little bit, we said we've moved to a more capital-light economy and so be it, in a sense that's a good thing, it means we can consume more of GDP and we don't have to put so much in to making up for capital that's wearing out. But there is a component that's a worry and that is that growth has been pretty slow in the non-mining economy in recent years and has failed to pick up, so we dug into that issue a little further. What we found, again, was not entirely as concerning as I guess on the surface it might look because when you disaggregate the non-mining economy in the following two ways, by state and by whether or not they sell services direct to mining, what you see is in fact in the non-mining states' investments picking up reasonably well. It's true that you've got quite a significant downturn playing out in WA and, to a lesser extent, in Queensland, but overall our conclusion from the exercise of trying to understand the investment bit of the economy is you can explain most of it away, and so we started to relax on that front. So what's left is the ever-present risk that we nevertheless might fall into a big shortfall from our potential in the way that you saw in much of the rich world in 2010 and we should raise that issue, Rod.

I guess the other angle is what if potential growth itself has slowed down? We've got an ageing workforce, productivity growth has been relatively weak in many economies, Australia has shared that, and so there's the prospect going forward, even if we don't fall well short of our potential, that our potential growth isn't as attractive or isn't as exciting or there's just not as much upside as there once was. If that's true, then there's going to be a period of community readjustment of expectations. I would argue that the community has already readjusted to some extent because we've had weak income growth as resource prices have come off, but we haven't yet seen a widespread recognition that there's the potential for much slower growth. I just wanted to share that introduction. That was why we were motivated. It's a very broad piece of work that we did and we don't have specific policy to-dos, unlike the case in many Grattan reports, we raise a set of issues that I'm hoping to touch on in the discussion. If I could start Rod with you, as somebody who's seen a set of recessions come and go over the years both as a student of economic history - you've been around the traps.

RODNEY MADDOCK: I've got more hair than you!

JIM MINIFIE: That's right. There's a sense in which is that assessment of the economy too rosy? Do you see rather more credibility on the other side that says actually, we're in a quasi-recession right now, we need to urgently do fiscal stimulus and we're much closer to the brink that what I've set out?

RODNEY MADDOCK: We're in a period of adjustment in the economy for a whole range of reasons. One is the resources boom changed the allocation of resources in Australia, shifted a lot of workers, as you know, to Western Australia and all those sorts of things, and as the exchange rate falls, the currency falls, people come back to other sectors in the economy. So we've got a lot of people moving between sectors and across the economy and that's always a difficult adjustment. If you look back in Australian history, you look at some of our earlier booms and we actually had much worse adjustment problems than we've got currently. The society has actually been, I think, adjusting as well as might be expected and perhaps better than we have historically. So I think that you've got to think about that. Then we've got another big thing going on with technological change and technological change is changing a lot of places where work is done and how work is done. Again, we're all struggling in all of our businesses and, I'm sure, our households in how to deal with technology change. It's a period of actually quite difficult adjustment and it's not surprising to me that firms don't quite know what to invest in and where to invest. So I think that the problem for firms at the moment in thinking about where to invest is actually quite difficult.

If you step back a little bit further and you say really the important thing in the economy in order to improve all our living standards is that we have good productivity growth then the question is where does productivity growth come from? One of the answers is as people invest they change underlying business processes and the better capital, new techniques actually mean that people become more productive. But the other thing that's going on, I work in a university, is that there's been an awful lot of technology that's become available to us as teachers which people aren't necessarily using very well. I mean, old buggers like me who learnt to teach with talk and talk, that sort of stuff, having to actually adapt to all the new technologies which are available, asking your students questions in class and having them all answer on their mobile phones, all those sorts of things, it actually takes quite a long time for all those sorts of process changes to happen. Universities are notoriously bad at it and I think it's going to take quite a long time. So if we think that a lot of the technological changes which are happening actually are ones which require process improvements as opposed to just having a new handset. Having a new handset's okay, but what you do with it is what might create extra value. For business to adapt to how we actually do things to these new technologies is another big challenge, so I think it's a really, really hard time at the moment for manufacturers and other producers, service providers to try and solve this adjustment of the labour force between sectors. We've had a big fall in the exchange rate and we've got all these new technologies. It's just bloody hard at the moment I think, Jim.

JIM MINIFIE: Let me drill into what we need to do to avoid what happened in 2009. I don't think anybody would say that we've got the sorts of risk factors that you saw in the US with very, very highly leveraged banks, not to mention the non-banking sector and the strong links into the European system, but nevertheless we do have a large financial sector compared to GDP, we've got a lot of household debt. There's one point of view that would say actually the rise of all of that household debt and the rise of house prices crowded out business investment. Now, we looked at that and found it's not really true, business lending as a share of GDP didn't change much, even as house lending rose, but reading between the lines and even now quite explicitly you can see that the financial regulators, Reserve Bank, APRA, ASIC and so forth, do appear to be quite concerned about that housing scenario. Do you have a perspective about did we get it wrong, did we let it get too large, and how are we going to unwind it if that's true?

RODNEY MADDOCK: You haven't been reading all those things I've been writing recently Jim. I'm very sorry about that, I'll have to send them to you.

JIM MINIFIE: But that's precisely why I posed you the question Rod.

RODNEY MADDOCK: It's, again, an interesting set of questions and a lot of discussion as to how we might evolve things in the economy. The problem that the Reserve Bank faces is that interest rates are really quite low and they're very reluctant to lower them further, which would normally provide stimulus to people to demand, or they're very reluctant to raise them very much because they know that investment already isn't strong and if they tried to raise them enough to actually slow down people's investment in housing it would have a very big effect on other investment, in machinery and things like that. So the Reserve Bank doesn't really want to raise rates and doesn't really want to cut rates, it's going to be very happy to sit where it is for a while. You then say, well, if you've got potentially a housing boom and you're the prudential regulator, APRA, what do you do? What they've done is to say let's try and bring in some rules which are specific to the finance sector, let's try and control lending for particular sorts of housing because we think that's where the problem is, and that lets the regulator address that particular problem without causing broader problems for the economy.

So I think that's a very, very good response in Australia by our regulators and they're all jumping up and down and making a lot of fuss about it, so it'll be interesting. I mean, if it was a group of firms who acted the way our regulators have recently I reckon the ACCC would be after them for some sort of co-ordinated misbehaviour. It seems very clear that the regulators have got together and said, "Let's get onto this together". So they're all coming in, almost day after day you see one regulator after the other. I think that it's a sensible thing to do to target the sector that they're particularly worried about. Whether it's a big problem or not is really unclear. It's very common to compare debt to income, so people talk to the debt GDP ratio in Australia and I think that's fundamentally wrong. You should compare debt to assets or income to the cost of servicing that. So the fact that you've got a large mortgage compared to your income is not really relevant. The size of your mortgage compared to the value of your house is a relevant thing, so you want to compare the debt to the asset, not the debt to the income. You have all these newspapers showing these horrible hockey sticks which look as if we're going to fall off some cliff in a minute, but if you actually go back and measure it in terms of have people's servicing costs on their loans gone up particularly, the answer is no and whether their leverage has gone up particularly you say probably not.

I'm much more sanguine about housing than the regulators, but it's their job. They're the prudential regulators, they should make these decisions and that's what we have, they're making them rather than me. But I'm less worried than they are.

JIM MINIFIE: I'm reassured so I'm going to go out and buy a house this weekend, if that's alright. If we can now completely shift gears to ensure that we touch on some of the policy questions. Miranda, you and I, and, in fact, Rod, you were there as well, were at an event today talking about changes to the company tax and it's been I think for all of us somewhat puzzling to see a government who simultaneously seems to hold two inconsistent main policy planks in mind. The first is we've got to get the deficit under control and the second is we've got to cut company taxes. So Miranda, can I ask you why has it come to the top of the agenda? Is this just purely the outcome of business lobbyists getting in the ear of a Coalition Government or is there something deeper going on that has meant that the company tax discussion actually is worthwhile having right now?

MIRANDA STEWART: Surely business lobbyists don't ever get in the ear of a Coalition Government? Surely that's not what's going on?

JIM MINIFIE: Well they'd like to push wages up by building the capital stocks.

MIRANDA STEWART: That's right, they want to push wages up. Before I answer that I might take a step back and that is that when you said before how can we avoid going back to 2009, what I thought you were going to say actually was how can we avoid going back to 1991? 1991, some may remember, others won't because you were born after that date, was the recession that we had to have and that recession had a really massive impact on employment, on people's lives; there were people who couldn't get jobs for a substantial period of time after that. That was very different from "just" having the financial crisis. So they are different beasts. I think it's interesting to think about both the company tax settings and also broader tax and welfare settings as framework conditions for both recessions and financial crises and that they might have different effects.

On the company tax rate cut, it's not just that the government's listening to the Business Council. There are a lot of things going on. You heard I think from Rod already that there are a lot of things going on and governments as well as businesses are operating on multiple dimensions, I think. The international dimension is this dynamic change that I think we're observing, you've seen it as company tax competition, rate competition, we're losing our competiveness rates, elsewhere are coming down. So that's definitely observable. You would have also seen all the news about base erosion and multinational tax avoidance and the use of havens. I think that base erosion problem is actually quite substantial, more substantial than it even looks from the data, because what is happening with investment into the country at least is that more and more of that investment is happening outside the corporate form altogether through trusts and managed funds in what we call stabled entities, and that is being lower taxed than the corporate tax rate. We are seeing quite substantial erosion, so the government is responding to that need to bring this foreign investment into the country and the company tax rate and base are part of the framework conditions for that investment, so that's a lever that the government can pull.

What's a bit odd I think that you raised about the current budgetary and political environment is that we seem to have ended up with only a company tax cut on the table and I would generally support that company tax cut, we can come back to that if you want. But it has a fiscal cost, it has a short term and a longer term fiscal cost and that fiscal cost is quite substantial. We do have a budget deficit, we need to finance that, and the government has not really proposed, excepting superannuation, a way to broaden the base to maintain and support that revenue for the budget in the longer term.

JIM MINIFIE: That's right and if you dig hard enough through the various Treasury papers you can form the view that the government appears to be planning to either get a windfall from other sources or to not fully adjust for the effect of inflation on the amount of personal income tax people pay to pay for the company tax cuts. So implicitly they're proposing, it seems to us, a shift in the tax mix away from companies and towards personal income taxes. Do you think that's the right mix shift?

MIRANDA STEWART: The models will tell you that company income tax is the worst as in the most inefficient, the most marginal excess burden, and that personal income tax is sort of next-worst. I think that's probably wrong. I think the personal progressive individual income tax is a highly efficient tax and actually collecting more revenue from that personal income tax is not a bad idea. We've always only periodically adjusted for inflation in the personal income tax, we don't have regular adjustments of the tax rates and brackets for inflation and we've always had that in the system. I guess the problem is though that that income tax rate structure is also under threat from some of the changes that Rod is pointing out, the changes in the nature of work, shifting individual services into corporate entities at the low end. I think giving a tax cut to small business is really, to be honest, completely the wrong way to go, it just creates more planning margins without any economic benefit. So we're seeing base erosion in some way in the personal income tax as well and really we should be trying to strengthen that base so that we can collect more revenue. I guess an alternative might be raising the GST or in addition, I don't know if you want to go there?

JIM MINIFIE: Would anybody like to vote on that? When we put a draft of our paper out one former politician wrote back saying, "Given that Grattan attempts to be grounded in the real world..." and suggested that we remove that proposal, I think their judgement was that -

MIRANDA STEWART: No, it's got to come.

JIM MINIFIE: We'll have a vote during question time, how about that? We've just touched on the surface of some of these tax transfer questions. To me, what I took away from the event we were at this lunchtime, and I made this point in the introduction, was that increasingly firms are able to operate across borders and to choose where they register their taxable income and where their assets live. Now that's not true for every type of firm so there are some constraints on that, but what that would tell you is that maybe it's not just a matter about changing the company tax rate. If you're in a world where there's always some tax haven out there and the product you're buying is an electronic service, so it's fairly nominal where the activity is actually occurring, do we have to think more radically than just a switch in the tax rate in order to attract that elusive international capital?

MIRANDA STEWART: We could change the design of the tax. I'm looking at you because the banks of course don't move and the large banks pay an awful lot of company tax, you'd have to say. If you look at the stats they're up there among the big payers, that's partly because moving is difficult for them because of regulatory reasons, which you may or may not think is a good idea. So we could rethink the design of the base and we could move along a spectrum like the US Republicans are considering, the Trump tax proposals would be what they call a cash flow tax. That would allow deductions for all of your investment, so your interested investment in this, and expensing all that investment would deny deductions for interest expense and it would lower the rate, that's what they want to do. We could go the other way and we could broaden the base to lower the rate potentially by denying deductions for financial type costs, like interest expense. There's a whole spectrum of things we could do. I guess the trouble is that even academics, I've heard substantial reasoned arguments for all of these different bases and we do have this kind of international game going on, in a way, and I think I am going to use my Jean-Paul Sartre quote at this point, which I saw recently. It's a quote about football which is that "everything is complicated by the presence of the other team". This is the dilemma that we face in corporate tax. There's a potentially really big and bolshie other team, and that would be the United States and we don't know what to do, we're watching what they're doing.

RODNEY MADDOCK: It's a funny use of "bolshie". I've never heard the United States described as "bolshie" before.

MIRANDA STEWART: You don't think they're bolshie?

RODNEY MADDOCK: Sorry, "bolshie" means Bolshevik, this is not normally something.

MIRANDA STEWART: No, "bolshie" doesn't Bolshevik does it?

RODNEY MADDOCK: Yes it does.

MIRANDA STEWART: It means like aggro.

JIM MINIFIE: Hundredth anniversary, they're both in play this year.

MIRANDA STEWART: I didn't mean Bolshevik, no, definitely not, I just mean kind of pushy.

JIM MINIFIE: That's a very quick whistle-stop tour around some of the tax issues and, for what it's worth, we go into this in a bit more detail in the report. Where we landed is that if you didn't have a budget crisis you really would think quite seriously about changing the company tax rate. While there are a lot of different parameters, we found the evidence that you would get a bigger capital stock if you cut that rate pretty compelling. The one proviso we'd add to that, and this was brought out very clearly in the Henry Review, Australia's Future Tax System Review, some years ago where what they proposed was a reduced company tax rate in conjunction with a new higher tax on natural resource rents, which of course didn't go through.

MIRANDA STEWART: No, it did go through. It was repealed.

JIM MINIFIE: But not for long, it led to the downfall of a government and so forth. What I learn from this type of discussion is I don't think this debate about how a small open economy taxes globally mobile firms is going to go away anytime soon and potentially, much like many other aspects of the tax system, we might be entering a very, very long game of cat and mouse where you never quite get to a notionally perfect system, but you're constantly inventing one way or another to try to counter some of the worst excesses of whatever people have invented to try to get away from paying tax in your jurisdiction, whilst simultaneously trying to be open and inviting to those mobile talent. Can I just broaden the discussion, there's a lot more to policy than just tax and beforehand I think we agreed if you put forward a summary you've got tax and spend, you've got regulation and you've got direct government ownership. Rod, do you see in the armoury of what policymakers can do credible things that a government today could do to ensure that we get better value, boost productivity growth by removing inefficiencies in the economy and help to boost our living standards that way, reallocating resources?

RODNEY MADDOCK: Energy is the obvious one that we're all scared of at the moment. The fact that Australia's now joined up with the World Energy Market really means that it's effectively doubled the price of energy to all of us and we have to accept that. What's happened in the short run though is that Australian prices have gone well above world prices and that's because of some problems with the way in which the export gas industry is operating. If you're a manufacturing firm in the western suburbs of Melbourne, I do some of my research out there, then you actually have only one firm you could buy gas from and they're probably asking you to pay four or five times as much as you did the last time you had a gas contract with them. That's going to make a big hole in a whole lot of people's potential to actually compete and I think there's a risk of a whole lot of firms closing down and probably not re-starting in Australia, even when the energy prices go back down. So if I actually wanted to do something immediately I would be trying to do something about energy exports. That's very immediate and a really big danger, I think, to the economy, so that's where I'd focus.

I wouldn't be reserving gas for Australia because that's a long term policy. I would actually buy out some of the contracts that some of those gas explorers have got. Selling the contracts overseas would cost the government a few hundred million dollars, but it's going to prevent very, very big problems in the manufacturing sector in particular. I really think that energy at the moment is a really dangerous sector for us all. All our bills are going to rise, some of that is inevitable and some of that is because of bad ways in which that system is working. It's a very heavily regulated sector, but they've made a mess of regulation. So it's not a case of market failure, it's a case of regulatory failure and that's something the government could get onto very quickly and solve, I suspect.

JIM MINIFIE: Miranda, do you have a shortlist of bright ideas the government ought to dust off and take a fresh look at?

MIRANDA STEWART: They're all to do with tax though. The big one that I think is really important to put on the table, which I do think the government is ignoring because, again, they see potentially a short term fiscal cost but I think there's a big long term gain, is the interacting effect of personal tax and the transfer system on women's labour supply in the market. The stats show that since the '70s women have been working more, the workforce participation is going up. Almost all of that in the aggregate - not individual women - is part-time work. Almost all the increase in workforce participation is part-time work and the reality is because of the way that we tightly means test and withdraw family benefits for children, the way we fail to fully subsidise childcare on a universal basis and we've made a stuff up of parental leave, the combination of those things means that women at child-rearing age, 20 to 40, let's say, face a different effective marginal tax rate structure from the average male worker. They pay much higher effective marginal rates, sometimes between 80% and 100%, on their next day, two days, three days of work. So, not surprisingly, being generally rational, they choose not to work in the market.

We've got an ageing population and we've got much lower fertility than we used to have. Why are we creating a system where the incentive is for women with various skills to specialise in home production and specialise in raising kids, instead of working in the market? That's something that actually is within the government's capacity, but it does have short term budgetary implications that need to be managed.

JIM MINIFIE: Grattan put forward a package along those lines in a piece we put out in 2012 *Game Changers.* One of the main three proposals was around fixing women's labour force participation, second earner, if you like, labour force participation where it's just not economic to do those fourth and fifth days a week for many people. Thinking more broadly, we've got, Rod, as you said, an economy that's shifting in its character. Picking up on an observation that you made Miranda about the personal income tax being actually a relatively efficient tax, would I be right in assuming that what you might have been alluding to is that a significant part of personal income can be thought about as a rent on your talent, and so that in respect it's a sort of efficient tax? Some people have got aptitudes that have got higher value in the market than others and, as a result, it's not inefficient to have a relatively high personal tax.

MIRANDA STEWART: I have to confess, that's not what I was thinking of, but you may have a comment on that Rod, I don't know. Very briefly, what I was thinking of was that actually people who face high marginal tax rates in their personal income tax don't change their working behaviour. They keep working, even if you tax them.

JIM MINIFIE: So you can pluck the goose and it doesn't squawk, as they say?

MIRANDA STEWART: Yes. What they might do though is tax plan and use entities and so on, take big deductions, various things, and that's about the base and making sure the base has integrity. But the rate, they'll keep working, so it's efficient in that respect.

JIM MINIFIE: Let me just build on that a little bit. We know that human capital is a huge part of the productive capital stock of a country. We've spoken a lot about the tax rate on commercial forms of capital, things that are alienated from particular people and can be transacted in the market. Do we have the tax system right for human capital and are we investing enough in it in the early days? So if you look back at the last election, effectively it was a debate between one side saying, "Let's invest in the commercial side" and the other side saying, "No, no, no, we're going to put it into education". Now Grattan got involved at different points in that discussion and there were essentially overstatements on both sides about the likely pay-off from their proposed plan, if I were to summarise. Do either of you see a big opportunity to do better on the human capital side, arguably bigger than the commercial side?

RODNEY MADDOCK: I was going to say, buggered if I know. It sounds like motherhood doesn't it, we should all invest in more education, we'll all get smarter and we'll all create more value for everybody. It's not clear that we're very good at investing in education. We've made lots of mistakes and it's awfully political, all those sorts of things. So I'm on the side, if I had more money I would be paying down debt because I think that's a burden on the next generation and I'd prefer to have them carry less debt in the future, less burden in the future, rather than spend it all, waste it all perhaps, on school halls and all sorts of things that schools didn't ask for, and pink batts and who knows what else.

MIRANDA STEWART: I think that was a subsidy for the construction sector, not education.

RODNEY MADDOCK: But it was marketed as being part of the education investment.

MIRANDA STEWART: If I comment on education policy I'm like, well, probably people in the audience know more than I do. I would have thought, again, we could invest in early childhood and there's a fair amount of empirical evidence that doing that is very good for the mass of young kids, it stands them in very good stead and lowers our fiscal cost of supporting people over the life course later. I guess the other thing that probably is worth exploring is that we do now think about the life course, of people moving in and out of work, in and out of education, people having long lives. The tax and welfare system operates as a stabiliser across the life course and it should do that, but maybe education funding should also do that better, but I couldn't say that I've got a solution to it.

RODNEY MADDOCK: Jim, my background story though is that I'm much less pessimistic about the world than you are.

JIM MINIFIE: We haven't got to climate change yet, right?

RODNEY MADDOCK: In most of Australia's history we've more or less tracked the productivity growth rates of the rest of the world and we're more or less doing the same again at the moment. So you've got to have a view on the world I think before you start racing off and doing all sorts of difficult policies, expensive policies in the hope of having Australia track on a different path to the rest of the world. I guess my view on the rest of the world is rather more optimistic. I think Brazil has bottomed, Russia has bottomed and the United States has actually bottomed and is starting to pick up, China continues to do well, India's doing well, Indonesia's still growing at around about 6%, and Europe, all the statistics there, the forward forecasts are looking better and the soft data is looking even better still. So I think that the world is actually doing better than let's just continue to project the current low growth rates globally. So being a bit more optimistic about the world, I'm less inclined to race in and make lots of policy changes.

JIM MINIFIE: It's a very well-made point and we also found precisely your observation, which is that there's an extraordinarily close, really a matching time path of productivity growth in Australia and in the rest of the rich world, right down to the turning point. So you go to 1974, or thereabouts, there's the slowdown, then you have a pick-up in the early 1990s and a slowdown again in the early 2000s. I too am quite optimistic that there's a lot of exciting technologies in the pipeline and that if we remain an open economy, a skilled workforce we're going to be well-positioned to take advantage of those opportunities. Let me now open it up to broader discussion and questions. We'll take three questions in a batch and process those, then move on.

AUDIENCE: Is it desirable to increase productivity given that the returns to capital and labour are so disparate that it badly affects equity in the system?

AUDIENCE: We know we have an ageing population, it's been on the cards for 40 years and we talk about it and talk about it. Where's the investment in older workers?

AUDIENCE: My question is about employment, underemployment and changing models of employment. I understand you're very optimistic, but should the workers of this country share your optimism, given the disparate way that the returns from the investments in productivity seem to be not being shared across society? What fuels your optimism that there won't be some kind of mass revolution?

JIM MINIFIE: So we've got two questions on productivity and equity, shall we have a go at those first?

RODNEY MADDOCK: I'll have a go at that. I think that when we go through a period of strong economic growth and strong welfare gains for everybody and then it slows down, that tends to lead to rethinking how the society works. I interpret the Thatcher and Reagan years as something of a response to the problems of the '70s after a long period of growth. Income was growing very strongly for most of the last 15 years, but then it slowed down and grew much more slowly subsequently. So yes, obviously all these questions get asked when you suddenly get a change in how things are growing. I think that the transfer system in Australia has been really outstanding in how well it's worked. Last time I looked at the data anyway, almost all of the redistribution in Australia was from the people in the top 20% of income distribution towards the people in the bottom 20% of income distribution, with not as much being wasted in the middle giving income to people who probably don't need it. I like a welfare system where you protect the poorest very, very clearly and let the rest of the world get on with its job. I think that the Australian transfer system has actually done a very good job and you compare Australia's transfer system with most other countries and I think we've probably had a better after-tax distribution than most similar places.

JIM MINIFIE: If I could just add to that, at Grattan we had a very stimulating talk by a fellow called Richard Baldwin, who's written a book about the effects of globalisation on income distribution within countries. His thesis is very simple and that is that the emergence of ICT (Information Communication Technology) permits what had previously been rich world technologies to be combined with poor world labour. So effectively the implicit social bargain between workers and multinationals housed in the advanced world in a sense has started to break down and workers have increasingly, at least in economies where that structural shift has been very large, like in the US, seen a big gap open between the wage experience, their market wage experience and the productivity of the economy overall, particularly the profitability of the firms who are able to arbitrage in that way. So all I would add to your point about the transfer system, Rod, is that if that becomes really material for Australia - which it could if services become more tradable because we're not really that exposed on manufacturing, it's a small sector of our economy now - we might have to think about a different income support model that doesn't deter labour force participation, even if the market wage rate for people becomes increasingly set by that international competition at the less formally qualified end of the labour market so you begin to look for things like the earned income tax credit or a negative income tax or something of that sort.

RODNEY MADDOCK: But there's no evidence yet. I listened to Baldwin as well, we had him present to us as and I thought okay mate, that's probably 20 or 30 years' time so I'll let these kids out here solve that problem.

JIM MINIFIE: But you've already seen, for example, quite a big shift. Full-time weekly earnings distribution has become more unequal, even as household incomes haven't become much more unequal because labour force participation has increased a lot at the bottom. So the pure hourly wage rate distribution has spread out in Australia, though not to the same extent that you've seen in the US because we've been on the good side of that global structural shift. I would share your question about to what extent you're going to suddenly find that significant parts of a service economy become more trade-exposed, but nevertheless my point was that just having a tax transfer system that potentially could support people's incomes but deter them from participating in the workforce might need to be adjusted to ensure that you're not deterring people.

MIRANDA STEWART: Can I just make a comment on that, actually, not really answering your question so much, but one of the oddities about the Australian company tax is that we have so much revenue in the company tax, we really do, much more than many other countries and you think why is that? Our imputation credit system is one reason, but another reason is that actually the share going to capital is increasing relative to the share going to labour, so corporate profits, and that is masking base erosion, in my opinion. We do have base erosion, but you don't really see it because you've got these big numbers in the tax collection. On the tax transfer system, it's been very effective, our highly targeted tax transfer system. One of the problems with that is there's very little room to move, there's very little place to save there, we've targeted probably as much as we probably can, and the other problem is these effective marginal tax rates that that produces for low income people moving into work and for second earners moving into work, and also for older people facing the pension and assets test moving into work. So you get these very high bumps and there is something potentially to be said for a more universal system which has a higher fiscal cost to manage that.

JIM MINIFIE: If we can move on to the other question in that first batch of three which was around what are we doing to support skill development in people who are mid-career to ensure that older workers remain engaged in the labour force? I want to put aside for now the issue about retirement ages and super access and so forth and talk about the re-skilling. To my mind, it comes directly to the question of what is the rate of return on your human capital investment and how does the tax system treat that? Miranda, do you have an observation on this? If I'm re-training to shift fields because my discipline vanished because of technological change, do I get to write off my investments in human capital against my future income or do I have a much less advantageous tax treatment than your average corporate does when they're investing in a new field?

MIRANDA STEWART: There are two pieces of this it seems to me, although I could do more thinking about it so this is just a fairly intuitive response. The first is that if you actually take time out, you take a year off, you go and study something else, and we're not taxing you on your time. I realise that seems odd, but we allow you to expense your time. We don't take the opportunity cost of the wages you would've earned and make you pay tax on it. You go off and educate, so in that sense we allow you to fully expense your investment in your new education. However, if you have to pay fees we don't allow you in that circumstance to tax-deduct your fees, whereas if you managed to keep working in a relevant discipline you can deduct, and I'm sure people in this room do that, like other businesses. But it's a bit like any deduction system, tax deduction or expensing favours a corporate or an entity that actually has income. If you don't have income that's measureable the deduction is not worth anything to you. Public education fully paid would be worth much more to you if you don't have any other income.

RODNEY MADDOCK: Yes and education is heavily subsidised still. Even though you pay fees, you're paying a third of the real cost or some number like that, you guys will know better than I. Yes, your education is still being heavily subsidised.

JIM MINIFIE: Yes, I think there's at least a 40% subsidy on fees. My sense is that that subsidy makes sense, given that you've got a highly progressive income tax system and, in a sense, it's offsetting the deterrents against people taking significant chunks out of their working life because they finally go in and they end up facing that higher tax rate.

RODNEY MADDOCK: We should just mention here a disclaimer that we've all got PhDs and we all spent a long time out of the workforce being trained.

AUDIENCE: I'd like to move perhaps a little bit away from the intellectual to the practical. My question is, how do we achieve a strategically sustainable policy framework bearing in mind several things, firstly, Canberra no longer has the staff and resources that it used to have 30 years ago, so that's a Federal issue. I've been in the energy industry internationally for many, many years. The energy situation we have today is very much driven because of a lack of foresight and policy, I mean, I can remember saying something 20 years ago which we're seeing today. In regards to interest rates I'm very concerned that an interest rate increase of 3% today is going to produce a much more severe reaction than happened in 1991, where if it went from 15% to 18% that was a much smaller increase. So it seems to be the root cause of what you've been talking about is always this lack of sustainable, strategic policy in government. What do you see as how we're going to actually address that, because that, to me, is the root cause?

AUDIENCE: I think we're all fairly intelligent in this room and can understand the concepts and the discussion that's been presented. We also live in a time of very populist politics and the so-called "pub test" that's now being talked about. Could I ask the panel members, can you convert what you've just said to us into 30 seconds of simple speak for pub talk that would help bring the people in the general population along on this discussion? Because, as the previous question highlighted, we've got some big wicked policy issues that need to bring the public along and our populist political system now is very aware of that. Apparently the Liberal Party is now in constant campaigning as a result of Andrew Robb's report. But, seriously, can you convert what you've said into a 30 second pub talk that would help, I think, explain some of the big changes that are needed?

AUDIENCE: The thing that concerns me is to do with the continual discussion of all these things. It seems to me plenty of people have got good ideas about how the economy and regulations might be changed, but in effect I'm suspecting that from the next recession the reason we'll have to have it is because governments won't have enough guts until they can see that the populace is willing to do more radical things. These days the newspapers don't discuss stuff very much, they haven't got the staff to do it, and the government doesn't tell us the basis for doing and not doing all of the various things, or at least I don't get to see it. It seems to me that in the modern world with all our communication possibilities there ought to be some way in which the public debate about all of the sorts of matters that we're talking about today ought to be able to be handled in a better way and somehow we should be collectively able to encourage the government to be a bit more gusty.

JIM MINIFIE: Quite inspiring. Can we add one more question?

AUDIENCE: While we're on the topic in the middle of everything we do, I want to bring a shift of focus to technological change. We always say businesses adapt very well and I heard Rod saying earlier that they do require process improvement, which basically means businesses will either downsize or right-size. Have you ever seen in the government the same kind of technological change being embraced to shrink in size or do something more efficiently than before, or anything else that will affect us?

JIM MINIFIE: Great question. Why don't we start with the first one around strategic capability? I think the question there was do we have really a fundamental gap in government capability, is that the thing that needs to be fixed? It's all very well to talk about specific policies, but there's something more systematic going on.

RODNEY MADDOCK: I think a lot about why Australia's succeeded in the long run, I'm trying to write a book on that, and I think that the quality of the policymaking has actually been really, really high for a very, very long time, more than a century and a half. So yes, it looks horribly messy on the inside but, compared to many other countries, we actually work our way through issues. So I'm very worried about the current situation where oppositions refuse to recognise mandates. We're in a democracy and if a government gets elected then really I expect the opposition to allow the main aspects of that legislation or proposal through to become legislated. I think that's just being a dreadful thing in Australia that we've got to the stage where after an election it makes no difference, nobody actually allows anything else through so the election resolves nothing. I think that's been the problem. I don't think the problem's with the policymakers, I think it's actually been the politicians have decided that just by negating they can actually create such a bad environment that the government will get voted out. I think that's the thing that most disappoints me about Australian public policy or public life at the moment.

MIRANDA STEWART: I think there's possibly a narrow issue that there are parts of departments in Canberra, for example, where there's been a real diminution in capacity and I do think that the Treasury has suffered somewhat from a short term cost-cutting exercise. When all the government departments had to do efficiency dividends, Treasury had to as well of course, fair enough, all departments, but all Treasury did was policy so I think the efficiency dividend in Treasury meant some cutting of some policy capacity there. I think that's soluble, that's something that's a bit like the business cycle, it goes up and down and you can probably rebuild that capacity. The bigger picture, we have this obsession with trying to get the politics out of it. Tax is all about politics. It's tax and welfare and public spending, it's all about the distribution of benefits and burdens and a vision for the nation, and that has to be political. So if we're going to spend a decade going back and forth, ping-ponging back and forth, we can't work out what we want exactly and in the process we make a bit of a mess of some things. It sounds bad, but it's only a decade so let's just keep the focus on the longer term. It's the politics that has to shift, it's not the policy.

For example, some people want to move fiscal policy out into an independent agency, some people want to take economic forecasting responsibility out of Treasury and put it into the Parliamentary Budget Office or some other agency. I think that's a mistake. Government has to be responsible for policy and government is accountable to the political electorate, so you've got to keep having these political fights. It is a talkfest, no doubt about that, but I think that's where you get the change in the end, in the politics.

JIM MINIFIE: I'm going to take that as an answer to several of those questions.

RODNEY MADDOCK: Can I answer the populist question?

JIM MINIFIE: Go for it.

RODNEY MADDOCK: Large enterprises create more jobs than small enterprises. It's true.

MIRANDA STEWART: Yes, they also pay more tax, I have to say.

RODNEY MADDOCK: Large enterprises pay a lot more tax than small enterprises. So there you are, there are a few pub lines you can run.

MIRANDA STEWART: Oh the pub test, yes, I was avoiding that question. The pub test to me would be first to ask a question, which is do you like the delivery of water, childcare services and public hospitals? Ask the question in the pub and maybe the answer is yes, maybe it's no. I think the answer is yes, so then the question is it's important that collectively we finance that in a sustainable way, while letting you keep a bit from your work and while letting businesses turn a profit, and that requires systemic reform of the tax system, including lowering some rates but also broadening and strengthening the system overall with tax reform.

JIM MINIFIE: For what it's worth, my version of that would be tax rents, not entrepreneurship and not human capital.

RODNEY MADDOCK: We should also ban the word "productivity" because whenever you mention productivity people think it means they're going to lose their job and that's ridiculous. So let's just ban the word "productivity" from public policy debate in Australia.

JIM MINIFIE: I'll have to change my job title! I think we've got time for two more questions, maybe three.

AUDIENCE: A number of the issues which have been so well-discussed tonight, energy, for example, and tax, identify for me a real challenge in the way the Australian Constitution works, or not as the case may be. I'm just wondering, with the comments about populism and short termism and the lack of strategic thinking, does the panel have a view as to whether we might be approaching the practical limits of a Constitution that was set in stone in the 1890s and is not really well-structured for dealing with national issues which are not mentioned constitutionally?

JIM MINIFIE: I'm glad you brought that up because I think we haven't had enough range in the discussion tonight!

AUDIENCE: I guess my question follows on from that, it's about the effects of federation on the tax system.

JIM MINIFIE: These are all questions for you Miranda, you're the lawyer.

AUDIENCE: Given that land tax started under Henry II, sales tax under Henry VIII, business tax under Elizabeth I and income tax under George III, is it time we actually reconsidered the whole tax system?

MIRANDA STEWART: Maybe we need to consider the Republic. I don't think there's anything really wrong with our Constitution. I actually think we've got a very successful and stable federation and we shouldn't underestimate how successful and stable it is. Again, when you look at other countries, it's a bit like our policymaking capacity, it looks shit but actually really it's not so bad. So that's not to say that the federation couldn't do with a bit of a kick and revitalisation, but it doesn't necessarily need Constitutional reform. One idea that I have published but hasn't got much interest, I must say, is that actually we could reconfigure the fiscal bargain somewhat between the national and the state governments. Looking at the way that Germany, a highly successful federation economically as well, allocates a substantial amount of income tax, more or less half the income tax base, which is nationally raised, and half the GST/VAT to the provinces and then the provinces more or less control what they do with that to deliver services for their population. So I'm in favour of sharing our national revenue bases more precisely and clearly and giving our state governments the ability to actually deliver services more effectively, while trying to eliminate some of the regulatory collisions that we have between the states.

RODNEY MADDOCK: I try to stay away from arguments about federation, they've been going on for more than a hundred years, I guess. There was a big tax blot I think in the original Constitution wasn't there, the Braddon Blot? In order to get the whole deal through they did a special deal with Western Australia, a side deal.

MIRANDA STEWART: Yes, that's right. Western Australia kept getting lots and lots of money until they started making money with the resources boom, and now they complain vociferously.

JIM MINIFIE: As they should. I'm going to declare victory for this evening. My sense is we've just scratched the surface of a huge range of topics. Miranda and Rod, thank you so much for your willingness to participate. I thank all of you as well for your engaged interest and I look forward to seeing you at future policy pitches where we'll tackle much narrower sets of topics in future. Thank you.

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